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The Second Clinton Administration's Policies Toward Korea and East Asia

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This is not my first time participating in a meeting of the Korea-US 21st Century Council. I have many old friends in the audience. But this is my first time speaking to such a distinguished group of Koreans and Americans as a government official rather than as a professor.

The East Asian Miracle

Three years ago Paul Krugman wrote The Myth of Asia's Miracle in Foreign Affairs. In some ways the article now it looks prophetic, given the economic slowdown that overtook much of East Asia last year, the downturn in the market for semi-conductors and other electronics, fears of over-extended property markets in many Asian cities, the financial problems afflicting some countries such as Thailand, and the deep malaise that seems to be afflicting others as they contemplate their economic future -- such as Korea, where the growth rate has recently slowed to 6% .

Korea now reminds me of a person who has climbed far up a ladder, very quickly, and now pauses to look down at the ground and suffers an attack of acrophobia. You are disoriented; you know in principle that you want to continue to climb up the ladder, following others like the U.S. that have gone before you. But you are apprehensive about the unknown future, and are reluctant to part from the rung of the ladder you are on, because at least it has the reassuring virtue of familiarity.

I do not believe that high Asian growth rates are a thing of the past. Nevertheless, I am going to suggest that the laws of economics may work similarly in Northeast Asia as elsewhere. U.S.-style economics may hold more lessons for other countries than we ourselves thought a few short years ago.

The word "miracle" lies in the eyes of the beholder. If Krugman had chosen to phrase differently ("The miracle of East Asian growth is due to miraculous rates of investment in physical and human capital"), most readers would have been less surprised.

Krugman pointed out that Alwyn Young had calculated that most of the growth in some East Asian countries, especially Singapore and Japan, could be explained by simple factor accumulation. There is no increase in total factor productivity left, to attribute to openness or stability or culture, or anything else. In this sense there never was a miracle.

Krugman claimed that there was little reason to expect rapid growth to continue in East Asia. Their economies would run into diminishing marginal returns to capital, and the inherent limits of rural-urban migration.

This verdict was overstated, for several reasons:

- catchup(the statistical tendency toward conditional convergence in incomes, representing in part the ability of late-comers to adopt frontier technologies and best-practice management practices from the rich countries)
- some countries as Korea do have large residuals
- openness, equality of income distribution, and macro fundamentals

There is little reason to think that the effect of these variables will diminish in the future, though the smaller the income gap with rich countries, the less the effect of catch-up.

<u>Is there a superior East Asian model of capitalism?</u>

- strong export orientation,
- long-term employer-employee relationships (vs. competitive high-turnover labor market),
- relationship-driven financial system (vs. Anglo-Saxon emphasis on securities markets and other arms-length transactions),
- firms maximize growth in market share (vs. profits or stock p),
- activist bureaucracy

I have in the past been shy about asserting the superiority of American-style capitalism over other varieties of capitalism. (1) The U.S. does not correspond perfectly to the laissez-faire neoclassical economy of textbooks, (2) some deviations from pure laissez-faire are in fact called for, and (3) American deviations are not always and in all circumstances precisely the best ones.

An example: the structure of financial systems. The U.S. model (shared with the UK and so sometimes called the Anglo-Saxon model) relies heavily on securities markets. To be sure, banks play a role; but even bank loans tend to be made on arms-length terms. Certainly the government has little to say about where bank credit is allocated. The Korean system, on the other hand, has been much closer to the Japanese model. The Asian model of finance features:

- high debt/equity ratios

C greater reliance on bank loans than on securities markets
C closer relationships between banks and borrowers
C extensive corporate cross-shareholding
C greater guidance from the government in their credit allocation

Five to ten years ago, economists were wondering if the Japanese system might not be superior to the Anglo-Saxon one. Research took both theoretical and empirical forms. The theoretical models assumed asymmetric information (between borrowers and lenders). The idea is that, from the viewpoint of a firm seeking to finance an investment project, the typical investors in the securities markets is a stranger, who has no way of knowing whether to expect your project to have as a high a return as you claim. Such investors will demand a premium to compensate them. The empirical tests confirmed that firms were better able to finance their investment projects internally, than when they had to go to the securities markets and convince strangers of the worthiness of their projects. Thus relationship banking was thought to be a possible way around the asymmetric information problems that impede capital markets....

The question ultimately was an empirical one. The Japanese and Korean systems seemed to work very well. They had produced high rates of investment and high rates of growth. In a 1993 paper I allowed that "One should hesitate before condemning Korean 'financial repression,' given how successful the development process has been over the last thirty years (p.96)." But I did add "Nevertheless, it may be time to move on to a new stage."

Now, four years later, I am prepared to conclude that it is indeed time for Korea to move on. The much-vaunted Japanese financial system is looking tarnished. The same might be said for Korea. We have only to consider the case of the Hanbo bankruptcy [in January]. Every country has its bumps in the road. One does not want to conclude too much from a single example. But I believe it fair to say that several aspects of the Northeast Asian model have been called into question by this episode: close relationships between banks and corporate borrowers, heavy government involvement in resource allocation, and special priority to industrial sectors that were once thought key to industrial development or strategic in export markets (in this case, steel).

Two Korean issues: financial liberalization and the frugality campaign

Every country is unique, and deserves its own institutions. Nevertheless, I would have to say at this point that emulating the American brand of capitalism looks like a pretty good strategy. I would urge Korea to proceed with its longstanding plans for financial liberalization. Of course Korea is already moving in the pro-market direction. The adoption of the real name policy in 1993 and joining the OECD in 1996 were two, very important, concrete steps toward economic maturity. I can't overemphasize the significance of these two steps. Both should help with the reform of the financial system into one that can help support the evolution of Korean industry.

My understanding, however, is that Korea has not yet accepted many of the OECD obligations in the area of financial liberalization [according to CRS and the FT, only 65 % of the OECD codes, compared to 89 % for the average member], that Seoul wants to postpone the rest until the current gap between Korean and foreign interest rates comes down (from its current 6-7 %). But the magnitude of this differential is precisely one of the best arguments in favor of removing controls on capital flows, so that capital will come in from abroad, and narrow the interest differential. Korean corporate borrowers would benefit enormously from the opportunity to borrow at the lower interest rates available on the world capital market. Of course the prospect of large net capital inflows raise issues of macroeconomic policy and sustainability of the current account deficit; I will return to them in a moment.

I would also suggest that Koreans might want to think more deeply about the rationale for the anti-luxury campaign. Of course, anti-import bias is the reason the USG is most concerned about this campaign. The Korean government claims that government policy does not itself discriminate against foreign goods. But even if assuming this were so, what is the reason for campaigning against consumption in general, or luxury consumption?

To return to the Krugman article, part of the argument was that Singapore and other East Asian economies have achieved their growth miracles by brute force: super-high saving rates, which depress the standard of living of the first generation in order to raise the standard of living of future generations. Now, thrift is generally considered a virtue; and we Americans will cheerfully admit that we do not save enough. [Our national saving rate has been recovering for the last four years; but even now it is much too low, especially if one allows for the current stage of our business cycle.] But it does not follow that higher saving is always better. Most of today's Singaporeans and Koreans grew up much poorer than will future generations of Singaporeans and Koreans. Why should the first generation make further sacrifices, on the margin, for the sake of descendants who will in any case be much richer? Why is it not appropriate that the current generation experience some of the countries' economic achievements in the form of a higher standard of living today?

One way or another, a campaign to reduce consumption and increase saving will have the effect of reducing imports and reducing the trade deficit, which I assume is the motivation. After all, the trade balance is income minus expenditure. A reduction in expenditure, even if not particularly directed at foreign goods, is nevertheless bound to increase the trade balance.

Thus both concerns -- financial liberalization and the anti-luxury campaign -- can be traced to Korea's concerns about its growing current account deficit and the dangers of international indebtedness. I understand such concerns. I do not agree with the Chicago-style economists who insist that international borrowing and lending, whenever it is the outcome of free decisions between consenting adults, must be optimal. History is replete with instances where countries have over-borrowed, and have ended up paying a steep price for their mistake when the period of adjustment suddenly comes. The most recent example is Mexico's peso crisis of 1994-95.

Some recent econometric research, looking at a large set of developing countries, indicates that the level of net capital inflows is not the key determinant of whether there is likely to be a subsequent crisis (e.g., Frankel and Rose, 1996). Rather, the key determinants are (1) what form does the capital inflow take? and (2) how are the funds used? With regard to the first question, FDI turns out to be a particularly stable form of capital inflow, and short-term portfolio flows a particularly unstable form. Central bank policy is also important: it helps to have a high level of foreign exchange reserves, and to avoid excessive credit creation and excessive overvaluation of the currency. With regard to the second question, if capital inflows are used to finance consumption, whether by the government or households, then the means of repaying the loans in the future will be unclear and the risk of crisis always present. But if inflows are used to supplement domestic financing of investment in physical capital, the fundamentals for long-term growth will be in place, and the risk of crises will be low. Investment in infrastructure may be particularly important. Investment in human capital, i.e., education, is equally important -- an area where Korea excels. [I would also add investment in the environment, even though it does not show up in future GDP and is not of much interest to international financial markets.]

Korea's current account deficit, at around 5 percent of GDP, bears watching. But Korea has an advantage relative to debtors in Latin America and elsewhere who have run into trouble with such deficits. Because the Korean economy is so export-oriented, such traditional indicators as the ratio of debt (or debt-service) to exports are still in reasonably good shape. To my mind, the existing econometric analysis of indicators of debt difficulties points toward the importance of allowing more FDI into the country. If more outward investment were allowed as well, then the net inflow would not be as large.

Other areas where I wonder if the Korean economy couldn't do well by moving in the direction of the American model include anti-trust and labor markets. Here I am seeking to raise questions, not to answer them, and am speaking as an economist, not as an Administration official. These are areas that each country must decide for itself. But American-style economics has a solution to the question of labor relations: the solution is to give workers complete freedom to organize and associate with whomever they wish, and at the same time give management the freedom to lay workers off. Why is such a policy not appropriate for Korea? Similarly, American-style economics has a solution to the question of industrial organization: it is to give corporations freedom from most forms of government regulation, but undertake vigorous anti-trust enforcement. Again, why is this not the right answer for Korea as well? A third example is banking: American banks are free to make their own lending decisions, but are then subject to prudential supervision.

The Clinton Administration's Policies Toward Korea and East Asia

So far, I have been speaking more as a university professor than as a government official. But the title of this session is the Second Clinton Administration's Policies Toward Korea and East Asia; and I think Fred would like me to talk directly on that subject.

Let me begin by saying that the 2nd Clinton Administration, like the first, is an internationalist administration. During the first four years, the crowning achievements [in the area of international economic policy] were the ratification and implementation of the NAFTA and the Uruguay Round. We hope and expect to continue this momentum in the second four years, as the President made clear in his State of the Union message.

This year, our single most important objective in the area of international economics is obtaining from Congress the authority to negotiate trade agreements on a fast-track basis. There are two aspects about which I should re-assure this audience. The first is that we are indeed committed to getting fast-track, notwithstanding some current delays in the process. The second is that you should view fast track as an indication of our commitment to an open rule-based multilateral trading system, notwithstanding that the first and most obvious uses for it may be regional, particularly negotiating the accession of Chile to NAFTA.

On the first point, we are pushing ahead full steam. The President has sounded the fast-track theme at every opportunity: the State of the Union message, visit of Chilean President Frei, recent speech before the Amer.Soc.News.Editors [4/11/97; 14 paragraphs], and a foreign policy retreat with Congress. The relevant Cabinet Secretaries are engaged, on the Hill and in public. Charlene Barshevsky has met personally with close to 100 Members of Congress, especially the new members. (Historically, some new members need help expanding their horizons to acquire a global perspective.) The WH is consulting closely with Congress to develop a bill that commands broad bipartisan support.

On the second point -- why those outside of the Western Hemisphere should want the USG to have fast-track authority -- we hope to be able to use it, not just in regional negotiations, but in multilateral negotiations as well. If we get sufficiently broad authority, possible areas of multilateral negotiation include agriculture, government procurement, and high-tech (e.g., ITA).

Moreover, I believe that the current movement toward regional trading arrangements is -- in a political economy sense -- consistent with worldwide movement toward liberalization more generally. It need not necessarily be this way. One can think of examples from history and reasons in theory to support the idea that regionalism undermines multilateralism. If I can return to being a professor again for just a minute, the Institute for International Economics is about to publish a book on <u>Regional Trading Blocs</u> that I wrote when I was a Senior Fellow there, before I started my current job. This study looks econometrically at how FTAs and other regional agreements have affected the geographical pattern of trade flows. The book finds, as one would expect, that such RTAs as NAFTA, Mercosur, the Andean Community, the European Union, and ASEAN have tended to boost trade among their members. One might also expect that this increase in trade would be at the expense of trade between members and non-members, i.e., that there would be trade-diversion. But the study finds that for most of these groups [EU, Mercosur and ASEAN], to the contrary, there has also been an increase in trade with non-members (though not as large as the increase with fellow members). The implication is that regional agreements, under present circumstances, can help build political momentum for liberalization with respect to non-members. I can assure you that those in the American political process who oppose NAFTA or its expansion into South America also seek to raise obstacles to free trade in the Pacific.

An example of how regionalism can support multilateralism is President Clinton's "Triple Play" of late 1993, which Fred likes to cite. As you recall, it was the President's idea to upgrade the Seattle meeting of APEC ministers that had been scheduled for November 1993, by adding a high-profile Leaders' Meeting. In this way, the United States signaled to the Europeans that if they continued to allow French farmers to hold up the Uruguay Round, other countries might proceed with other initiatives without them. This message carried credibility because of its fortunate timing, coming as it did on the heels of the hard-fought approval of NAFTA in the U.S. Congress. Thus, the NAFTA outcome demonstrated the political will necessary for meaningful agreements, while the APEC meeting demonstrated the possibility that agreements would cover a fraction of the world economy that was sufficiently large and dynamic to give the Europeans cause for worry at the prospect of being left out. In this episode at least, it appears that regional initiatives helped bring about multilateral agreement.

On the subject of APEC, the Second Administration is committed to remaining engaged in East Asia and the Pacific -- and APEC is an important manifestation of this commitment. We look forward to the next summit of Ministers and Leaders in Vancouver. Speaking for the CEA, we are very pleased that Korea, in the form of

KIIEP, will be directing the preparation of the APEC Economic Outlook, which we were heavily involved in last year in the preparation for the Manila Summit. And I would like to take this opportunity to congratulate Soo Gil Young on his appointment as President of KIIEP. We look forward eagerly to working with him.